Office Sector Maintains Steady Course; Growing Demand, Higher Completions Expected

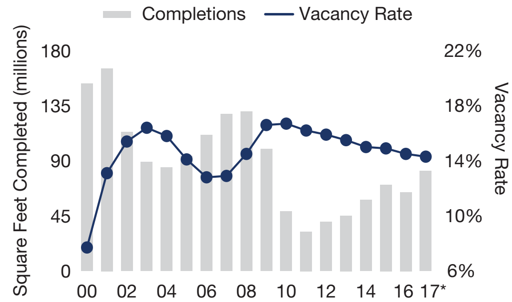
New trends transforming office landscape. Growing space demand, declining vacancy and consistent rent growth provide opportunities for office property investors to enhance asset performance. The decline in the U.S. vacancy rate in 2016 marked the sixth consecutive annual decrease and also highlighted emerging trends that could become more firmly entrenched. Most conspicuously, the outperformance of CBD properties led the office sector out of the recession, but the suburbs have been gaining ground and making larger contributions to overall performance. Recently, a disproportionately greater share of total net absorption is attributable to suburban properties, and the gap between CBD and suburban rent growth is narrowing. In addition to the disparity in CBD and suburban asset performance, tenants remain innovative in their use of office space. Technologies that facilitate remote working arrangements are becoming increasingly common while greater reliance on contract workers and smaller staffs of centralized full-time employees have converged to reduce traditional worker space ratios.

Construction modest by historical standards. Subdued construction continues to contribute to the performance of the office sector by diverting new space demand to existing properties. Property owners and investors rarely had to consider competition from new supply as a factor affecting asset performance throughout the current cycle, and supply pressures will only modestly intensify during 2017. This year will likely mark the high point in completions for the current cycle as construction lenders maintain a conservative stance on office development and the best sites are used for residential properties. Collectively, completions in San Jose, Dallas/Fort Worth, Seattle-Tacoma, Houston and San Francisco account for more than one third of the new square footage scheduled for delivery in 2017, and other metros will face minimal pressure from new supply. Beyond 2017, construction will likely occur in select suburban locations with walkable central cores and access to major transportation routes and mass transit, factors that are becoming increasingly important to office tenants.

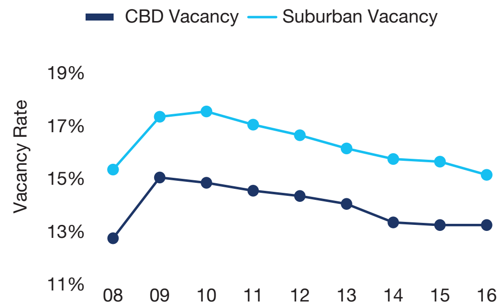
2017 National Office Market Outlook

- **New supply will challenge CBD markets.** Developers will complete 82 million square feet of space this year, exceeding the amount of new space delivered in 2016. New buildings in CBD locations, where space demand growth has eased recently, may face longer periods to stabilize. The share of demand growth in suburbia, however, is growing, a trend that will persist in 2017.
- **Demand growth fuels improvement in performance.** Net absorption of approximately 83 million square feet will outpace completions and generate a 20 basis point decline in the U.S. vacancy rate this year to 14.3 percent, marking the low point of the current cycle. The projected level, though, remains above the pre-recession low. The reduction in vacancy will support an increase in the average asking rent of 3.5 percent.
- **Changing demographics drive structural shift in office demand.** As the millennial generation reshapes the workforce, tenants will favor assets that engender community and cohesion. Popular amenities include recreation spaces, on-site medical offices, restaurants, and childcare centers. A growing number of newly-formed millennial families will migrate to "urbanized" suburbs with walkability and proximity to city centers, making office assets in those types of location a compelling investment opportunity.

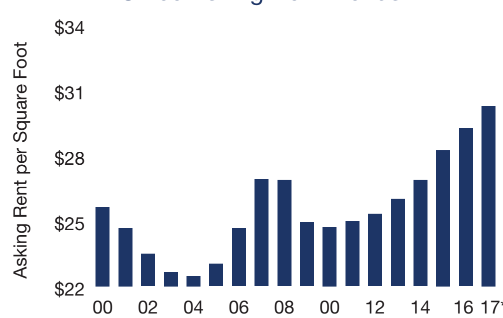
Office Construction and Vacancy



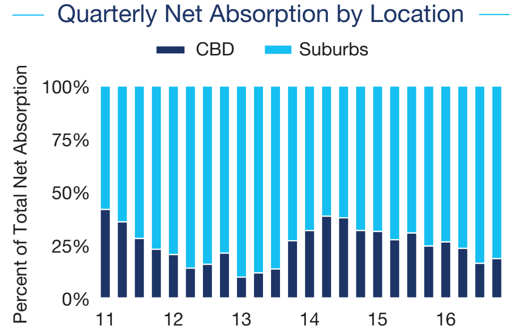
Vacancy by Location



Office Asking Rent Trends



Quarterly Net Absorption by Location



* Forecast

Sources: CoStar Group, Inc.; Real Capital Analytics